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Turning the IRS into a Beast

Closing the Tax Gap: Not the 'Pot of Gold' That Some Hope to Discover

Executive Summary

- In anticipation of the Senate Budget Committee markup of the annual budget resolution, much attention has been given to the revenues that Democrats hope to count on by “closing the tax gap.”
- Unfortunately for Democrats, there is no pot of gold hidden within the tax gap for them to finance their desired spending increases.
 - That is because any solution that attempts to *reduce* the tax gap on a large scale necessarily must *increase* the burden on taxpayers and *decrease* taxpayer rights.
- This paper attempts to make just one point: while the concept of significantly increasing taxpayer compliance may *appear* justifiable on paper, the practical impact of implementing it could be devastating to the individual taxpayer.
- Secretary of the Treasury Henry Paulson said, “I don’t think it does anybody a service to let the American people think there’s a big pot of gold there and that we can tap into that gold to fund all sorts of things without there being a big cost to that....”
- President Bush, in his FY 2008 budget request, outlined 16 different solutions for closing the tax gap.
- It is critical for policymakers to consider the revenue effects alongside the ramifications to taxpayers’ dignity, privacy, and their loss of time due to compliance requirements. Nevertheless, in their ideal budget resolution, Democrats will venture beyond the President’s proposals.
 - Some have suggested they may plug in a figure in the neighborhood of \$100 billion over the five-year budget window from increased taxpayer compliance.
- This paper provides examples of actions Congress could — but hopefully never would — impose on taxpayers to increase tax compliance.

Introduction

In anticipation of the Senate Budget Committee markup of the annual budget resolution, much attention has been given to the revenues that Democrats hope to count on by “closing the tax gap.” Budget Committee Chairman Conrad recently said, “I think the first place we ought to look for revenue is not a tax increase. The first place we ought to look is this burgeoning tax gap.”¹ The tax gap is an estimate of the difference between the taxes – individual, corporate, employment, estate, and excise – that *should have* been paid voluntarily and on time and what was *actually* paid for a specific year. The Internal Revenue Service (IRS) estimates that in 2001 the gross tax gap was \$345 billion and the net tax gap, which is computed by subtracting late payments and taxes eventually collected from the overall tax gap, was about \$290 billion.² [For a more detailed look at the tax gap and the efforts to reduce it, see RPC paper, “*Understanding the Tax Gap*,” issued on September 12, 2006.³]

Clearly everyone would agree that paying one’s taxes is a civic responsibility of every American, and those who fail to pay place an increased burden on compliant taxpayers. Unfortunately for Democrats, there is no pot of gold hidden within the tax gap for them to finance their desired spending increases. That is because any solution that attempts to *reduce* the tax gap on a large scale necessarily must *increase* the burden on taxpayers as well as *decrease* taxpayer rights. This paper attempts to make just one point: while the concept of significantly increasing taxpayer compliance may *appear* justifiable on paper, the practical impact of implementing it could be devastating to the individual taxpayer. Without fundamentally — and negatively — changing the relationship between taxpayers and the IRS, the revenue gains found from increasing tax compliance are likely to be only marginal.

Easy-to-Collect ‘Pot of Gold’ Does Not Exist

Over the course of many years, numerous solutions have been proposed to address the tax gap,⁴ but history reveals that there is no silver bullet, no quick fix. Rather, addressing the tax gap requires the consideration of various competing issues, such as burdens, benefits, and resources, in order to develop the most comprehensive and cost-effective plan. Secretary of the Treasury Henry Paulson, during a Finance hearing on February 6, 2007, said this of compliance efforts:

¹ Senate Budget Hearing, The President’s Fiscal Year 2008 Budget and Revenue Proposals, February 8, 2007 — http://budget.senate.gov/democratic/statements/2007/hrngstmt_paulsontrans020807.pdf. Senator Schumer, during a Finance Hearing on February 6, 2007, said: “To me this [closing the tax gap] is the best way to raise revenues...”

² “IRS Updates Tax Gap Estimates,” IR-2006-028, from www.irs.gov/newsroom/article/0,,id=154496.00.html, February 14, 2006.

³ <http://rpc.senate.gov/files/Sep1206TaxGapSN.pdf>.

⁴ For example, in 1993 the IRS formed a task group that performed an extensive review of the tax gap. The resulting task force report provided several recommendations: (1) enforcement is the most costly option and delivers only limited revenue; (2) methods to increase voluntary compliance are less costly but more burdensome to taxpayers; (3) legislative changes are needed as the primary means to increase compliance levels; and (4) the IRS needs to reevaluate its media and taxpayer education efforts. IRS Tax Gap Report: *Strategies for Closing the Tax Gap*, Oct. 1993.

I think we owe it to the American people to take some of the mystery out of this...Because I don't think it does anybody a service to let the American people think there's a big pot of gold there and that we can tap into that gold to fund all sorts of things without there being a big cost to that....And if there are other things that we could see that would be more harmful than helpful and wouldn't be in our judgment bad policy, we'd be proposing them.⁵

Many Tax Gap “Solutions” Are Really More Problem than Solution

It is important to acknowledge that essentially all efforts to reduce the tax gap are costly to implement because they involve either educating or policing the noncompliant taxpayers, as compared to simply receiving funds from compliant ones. President Bush, in his FY 2008 budget request, outlined 16 different solutions for closing the tax gap that altogether are estimated to raise \$29 billion over 10 years.⁶ It is anticipated that JCT will come out with a lower estimate. The methods the President selected are likely to be the ones that are the most cost-effective and the least painful to the taxpayer. They include proposals to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties.⁷

It is critical for policymakers to consider the revenue effects alongside the ramifications to taxpayers' privacy, dignity, and their loss of time due to compliance requirements. Nevertheless, in their ideal budget resolution, Democrats will venture beyond the level proposed by the President. Some have suggested they may plug in a figure in the neighborhood of \$100 billion over the five-year budget window from increased taxpayer compliance. Such a figure can either be looked upon as “pie in the sky” or as Democrats' willingness to essentially declare war on the American taxpayer. Consider the warning of Pamela Olson, a former assistant Treasury secretary for tax policy under President George W. Bush: “Turning the ‘tax gap’ into a pot of gold requires turning the IRS into a beast. They [Democrats] might be able to do it, but they won't like the result.”⁸

It is essentially a baby-and-bathwater dilemma because actions taken necessarily will affect law-abiding taxpayers as much as they will tax evaders. A variety of actions that are available for Democrats to turn to as “solutions” really raise problems bigger than the solutions. They are problems that no one — Republican or Democrat — would want to actually impose on taxpayers or on the nation's economy. They “would require thousands of new Internal Revenue Service agents as well as stricter filing rules, more stringent audits, tighter scrutiny of small

⁵<http://www.cq.com/display.do?dockey=/cqonline/prod/data/docs/html/transcripts/congressional/110/congressionaltranscripts110-000002447652.html@committees&metapub=CQ-CONGTRANSCRIPTS&searchIndex=0&seqNum=2>, page 23.

⁶<http://www.treas.gov/offices/tax-policy/library/bluebk07.pdf> at page 61.

⁷<http://www.treas.gov/offices/tax-policy/library/bluebk07.pdf> at page 61.

⁸Ryan J. Donmoyer, “Democrats’ Revenue Plans Might Mean Turning Taxman Into ‘Beast,’ ” *Bloomberg*, March 5, 2007 — <http://www.bloomberg.com/apps/news?pid=20601070&sid=aU8SELY0OrWM&R>.

businesses, and other politically unpopular steps that [Secretary] Paulson says would penalize ‘honorable and honest’ taxpayers.”⁹

The following are six examples of actions Congress could — *but hopefully never would* — impose on taxpayers to increase tax compliance. The following are an illustrative presentation of the current situation: the “tax gap” is a very tough nut to crack.

1) Solution? 1099’s for ALL Consumer to Business Transactions

Requiring all consumers to provide Form 1099 information reports on any payments they make to businesses is one way to close the tax gap. Yet, in practicality, this would mean that every time that an average American pays for a service they would not only need to provide the business with a Form 1099, but also send a duplicate copy to the IRS as well. For maximum effectiveness, the 1099 forms would have to cover **every** transaction during that year with no minimum amount for reporting. One can only envision the privacy invasion and time cost that would result from this requirement:

- Every visit to an auto mechanic, veterinarian, dry cleaner;
- All payments on a car loan;
- Every payment to a plumber, washing machine repairman;
- Every payment to a utility company
 - Telephone
 - Gas
 - Electric
 - Water
 - Cable;
- All rent payments to a landlord or mortgage payments to a lender; and
- Every visit to a health care provider
 - Doctor
 - Dentist
 - Optometrist
 - Orthodontist.

Going one step further with the 1099 reporting option that could further increase revenues: to require all consumers to withhold a certain portion of what they pay to a business for a product or service and to send that amount to the IRS at the end of the year along with the Form 1099. In reality, this would merely accelerate many tax payments and impose burdens on taxpayers who would ordinarily make the payments.

2) Solution? Require Non-Profits to Report ALL Contributions

Another option would be to require charities to report to the IRS the names and amounts that individuals contribute to an organization, whether it is cash payments, or in-kind contributions. To be maximally effective, no minimum amount would be required for reporting.

⁹ Ryan J. Donmoyer, “Democrats’ Revenue Plans Might Mean Turning Taxman Into ‘Beast,’ ” *Bloomberg*, March 5, 2007 — <http://www.bloomberg.com/apps/news?pid=20601070&sid=aU8SELY0OrWM&R>.

This would assuredly make people think twice before making charitable contributions, given the invasion of privacy that this option would impose.

3) Solution? Mandatory Withholding on Certain Types of Income — Interest, Dividends & Pension Payments

Under this option, some portion of payments of certain types of income (interest, dividends and pensions) to individuals would have to be withheld. Mandatory withholding would apply to:

- Monthly interest paid on savings accounts;
- Income earned from stock or mutual fund dividends;
- Pension payments; and
- Social Security payments.

As noted above, withholding generally accelerates tax payments that would be expected on income already subject to reporting. Again, this would amount to a true fiscal burden for low-income earners, while assuring government receipts — even if they were later fully refunded to the taxpayer.

4) Solution? Restore the IRS of Old: Unfettered Seizure and Levy Authority

Granting the IRS broad authority to seize and levy vast amounts of property from taxpayers who fail to pay the taxes they owe is another option. In the past, the IRS possessed such broad authority, but that power was significantly scaled back in the 1990s because of rampant complaints of abuses. Restoring IRS' ability to go after delinquent taxpayers would help with tax collections, but at what cost to the public in terms of a return to reported abuses in the past?

5) Solution? Eliminate Cash Transactions & Mandate that Consumers and Businesses Keep Records of ALL Electronic Payments

In order to crack down on unreported cash transactions, one option would be to prohibit all cash transactions. Consumers and businesses would be required to conduct all transactions with a credit or debit card, and all purchases would subsequently be reported to the IRS. This would mean that for every credit card statement the American consumer or business receives, an identical copy of such statement would also be sent to the IRS. Similarly to the extent they use a debit card, their bank statements would also go to the IRS. This would represent an enormous hardship to lower income people and others who prefer cash transactions, not to mention the privacy concerns inherent in having the IRS have records of every single electronic transaction that every American makes.

6) Solution? Increased Auditing Until IRS Achieves Full Compliance

If the legislative solutions mentioned above don't hold enough disturbing potential, one final option would be to provide at least one revenue agent (auditor) to monitor a certain number of small businesses and entrepreneurs in a given geographic area. With nearly 26 million small businesses in the United States, this option would mean that an IRS agent could spend several days per year with each business in his or her region in an attempt to increase and monitor compliance.¹⁰

Fortunately for tax-compliant businesses, this is probably not a cost-effective option. With the approximate salary for an IRS auditor being roughly \$100,000,¹¹ the IRS would need 258,000 new agents if they were to each handle 100 small businesses a year, which would require a \$25.8 ***billion*** increase in the IRS budget. The President's FY 2008 budget request to fund the entire IRS for the next fiscal year is \$11.4 billion.¹² This means that in order for the IRS to put in place one auditor to monitor 100 businesses a year, the IRS budget would have to more than TRIPLE.

Extending the increased auditor option one step further would be a requirement for every American to be assigned an IRS agent to whom he/she must report in person on a periodic basis. Such face-to-face meetings might serve to reduce noncompliance but would never prove to be cost effective. After all, the bedrock of our tax system is its voluntary nature.

Conclusion

The magic 'pot of gold' that some lawmakers think closing the tax gap will yield is not realistic and cannot be achieved without extensive burdens on the American taxpayer. Realistic improvements can, and should, be made to reduce the tax gap — beginning with the President's 16 proposals is a good place to start. In reality though there will *never* be 100 percent compliance.¹³ Unrealistically high compliance rates theoretically would drive the country into a tax system that would require highly intrusive third-party reporting requirements and an agent in every household and in every small business. The practical effect would be the replacement of our "voluntary" tax system with a police state...a result that no one wants.

¹⁰ <http://app1.sba.gov/faqs/faqindex.cfm?areaID=24>.

¹¹ http://www.treas.gov/offices/management/budget/budget-documents/cj/08/12_IRS_CJ_GTG.pdf.

¹² http://www.treas.gov/offices/management/budget/budget-documents/cj/08/12_IRS_CJ_GTG.pdf.

¹³ The IRS has set an 85-percent compliance goal by 2009.